

**PREPARED TESTIMONY  
OF  
COMMISSIONER OF INTERNAL REVENUE  
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BEFORE THE  
SENATE FINANCE COMMITTEE  
PROMOTED TAX SCHEMES  
APRIL 11, 2002**

**INTRODUCTION AND SUMMARY**

Mr. Chairman, thank you for this opportunity to discuss the IRS' efforts to identify and combat actively promoted tax schemes. As I testified at last year's Finance Committee hearing, they are organized, actively promoted and geared to almost every pocketbook. The broad spectrum of promoted schemes runs from the patently frivolous, such as "Untax Yourself for \$49.95" packages sold over the Internet, to the most sophisticated and complex abusive tax avoidance transactions that are promoted by tax advisors to large corporations and very wealthy individuals.

Identifying and combating actively promoted tax schemes is our highest compliance priority. One reason is the money lost to the Treasury, which is clearly substantial. But, even more important, these promoted schemes are unfair and corrosive to the health of our tax system. Nothing undermines confidence in the tax system more than the impression that the average honest taxpayer has to pay his or her taxes while more wealthy or unscrupulous taxpayers are allowed to get away with not paying.

In addition, these illegal tax schemes place a major demand on IRS resources. A complex illegal offshore trust case could require several times as many hours as a typical exam, and thousands of these cases are emerging. At the same time, we cannot abandon our traditional compliance activities to focus solely on these schemes. No taxpayer should ever believe that he or she could ignore the tax law and get away with it.

As can be seen in the attached chart, there are a variety of schemes that are promoted to a wide range of taxpayers. Combating each scheme requires an approach tailored to the nature of the scheme. However, as shown in the second chart, our strategy includes the use of a full range of tools and techniques. These include:

- *Identifying the promoters and the schemes* through summonses of records, audits of promoters, disclosure regulations, and active analysis of leads from all sources;
- *Identifying participating taxpayers* through audits of promoter records, screening of tax returns, and matching of documents;

- *Providing specific warnings* to the public and to potential promoters through issuance of official notices well as through the media, partnerships with practitioner and business groups, and letters to potentially affected taxpayers;
- *Taking enforcement action against promoters*, including civil injunctions, civil penalties, and criminal investigations. In this regard, since last year, we are working closely with our colleagues at the Justice Department to establish a parallel approach where we can seek civil injunctions while criminal actions are proceeding. This will be a major breakthrough as these promoters often continue to operate while criminal investigations are taking place.
- *Taking enforcement action against participating taxpayers*, including audits, civil penalties and criminal investigations.
- *Taking action to measure the size of the problem* and improve identification methods for the future.

Mr. Chairman, although we are making substantial progress on rooting out and shutting down promoters and schemes, a number of challenges remain. We are grappling with a widespread and growing problem made more difficult by new sophisticated techniques and modern technology. Indeed, the Ranking Member, Senator Grassley, was correct in his recent comment made to the *Los Angeles Times*: “Since tax cheats are endlessly creative, the IRS has to be just as creative to catch the crooks.”

However, our limited resources also force us to focus on only the most egregious and highest priority cases. Given these facts, we are continually seeking innovative ways to stop these promoted schemes. Our initiatives to measure and identify the impact of this and other forms of non-compliance are an important step in this regard.

Let me also stress the importance of the support we are receiving from the highest levels of our government to combat the promoters and schemes. This visible commitment to find the people who promote and engage in these schemes and hold them accountable has a big impact in deterring the activities just described. It also encourages the prosecutors, courts and front-line employees to be more effective in their important work. In this regard, I want to thank Secretary O’Neill both for his support of the IRS and for the initiatives he has proposed on behalf of the Administration. In addition, Mr. Chairman, let me thank you and the Committee for holding this hearing which demonstrates both the gravity of the situation and the united front we are putting together to address it.

## **TYPES OF SCHEMES**

Mr. Chairman, I will now attempt to describe the largest and most prevalent tax schemes and the actions the IRS is taking to combat them. Again, to aid in understanding this complex area, we prepared two charts.

The first describes and provides examples of the four broad categories of promoted schemes: (1) false descriptions of the law to claim exemption from tax, or improper deductions and credits; (2) misrepresentations of the facts to claim improper deductions and credits; (3) use of trusts and/or offshore bank accounts to hide income; and (4) abusive tax avoidance transactions.

I would also note that the IRS continues to identify new abusive tax schemes, tax refund schemes, and frivolous return filing schemes. There is no geographical pattern to them. These schemes are located throughout the country and some of the schemes are marketed nationally.

As previously described, the second chart summarizes each category of tools that the IRS is using to combat these scams and schemes. Indeed, the following statistics demonstrate that the IRS has made enforcement in this area a top priority.

In FY 2002, we had 104 promoter cases approved for examination (audits). We also had three injunctions (1 preliminary and 2 permanent); injunction suits pending in district court against 14 promoters and injunction suit referrals pending with DOJ against 4 more promoters. And over the past 17 months in the criminal area, 21 promoters of abusive trusts have been indicted, 26 have been convicted, and 70 are under active investigation.

## **FALSE DESCRIPTIONS OF THE LAW INCLUDING SECTION 861 AND EMPLOYMENT TAX FRAUD**

### **What They Are**

Since shortly after the federal income tax was enacted in 1913, some individuals and groups have encouraged others not to comply with the law. Using a variety of arguments, unsuccessful challenges have been made about the applicability of tax laws. There have been assertions that the 16<sup>th</sup> Amendment was not properly ratified; the tax law is unconstitutional; and the income tax only applies to certain individuals, or violates one or more constitutional rights.

Some individuals falsely claim that pursuant to Section 861 of the Internal Revenue Code, Americans are exempt from taxation on income earned within the United States. They argue, instead, that federal income taxes are excise taxes imposed only on nonresident aliens and foreign corporations for the privilege of receiving income from sources within the United States. These scams frequently, referred to here as “Section 861’ schemes go under the names of “Zero Tax” or “Employer Abatement” promotions.

One of these Section 861 schemes, which has been actively promoted in recent years, instructs employers not to withhold federal income tax or employment taxes from wages paid to their employees. Unfortunately, in these cases, the employees can be left holding the bag. They still have the responsibility to pay income taxes and are ultimately responsible for their share of FICA tax.

Another scam lures taxpayers into believing that they can get a refund of the Social Security taxes paid during their lifetime. The victim often pays the promoter and accomplice a “paperwork” fee of \$100, plus a percentage of any refund received, to file a refund claim (Form 1041) with the IRS. Of course, this is nothing more than a hoax designed to fleece the victims for the up-front fee. The law does not allow such a refund of Social Security taxes paid.

There is also no provision in the tax law that allows African-Americans to receive tax credits or refunds related to slavery reparations. However, unscrupulous promoters are shamelessly deceiving people into paying money for advice on how to file these false claims, in which they generally seek \$40,000 to \$80,000, but in some cases up to \$500,000.

All of these patently false arguments have no legal basis whatsoever, and despite the courts having consistently rejected them, their promoters continue to expound and market them, particularly to unsuspecting taxpayers and small businesses. These taxpayers may even incur penalties for bringing frivolous cases into court or for filing frivolous tax returns. In the 1980s, Congress, concerned about taxpayers misusing the court, enacted a law allowing the courts to impose a penalty of up to \$25,000 when they deem a taxpayer’s argument frivolous.

Mr. Chairman, I would also note that in the Administration’s FY 2003 Revenue Proposals, the President proposes to increase from the current \$500 to \$5,000 the penalty for frivolous returns and to extend this penalty to other frivolous submissions that are designed to delay the collection of tax. On March 20, 2002, the House Ways and Means Committee reported out legislation containing this provision.

### **Identifying Promoters and Taxpayers**

Mr. Chairman, we have a number of tools at our disposal to identify scam promoters and participants. There are the traditional ones, such as audits, where we uncover schemes during the routine examination process. We also encourage and receive tips from taxpayers about all types of tax fraud. Anyone can report suspected tax fraud to the IRS by calling 1-800-829-0433. They can also contact the IRS by sending an e-mail to [irs.tax.shelter.hotline@irs.gov](mailto:irs.tax.shelter.hotline@irs.gov).

Over the past few years, we crafted programs and tools to deal specifically with the problem. In FY 2000, we created the Frivolous Return Unit (FRU) at the Ogden IRS campus to focus specifically on combating false and frivolous claims. The Frivolous Return Program (FRP) centralized the processing of these documents and, in the course of its activities, protected \$3 billion of revenue for FY 2001 and developed nationwide employee training keyed to this problem.

Beginning in October 2001, this unit, working with all 10 submissions processing sites, has detected about 145,700 frivolous claims made up of 91,800 reparations claims, 8,500 other frivolous returns (such as employment tax cases) and 45,500 correspondences

using frivolous arguments to respond, for example, to collection notices and exam assessments.

In addition, since March 1999, approximately 8,126 Form 1041 returns claiming Social Security Refunds have been filed and detected. They claimed \$794 million in refunds and came from 46 states, the District of Columbia and Armed Forces in Europe. The IRS was successful in blocking about 99.6 percent or all but 129 of these false claims. The 129 claims that were not detected claimed \$10 million in refunds. We have since recovered \$6 million and are still actively pursuing the \$4 million balance.

Slavery reparations claims proved to be a growing problem. In 2000, the IRS received and detected over 13,000 claims, and during 2001, over 90,000. Again, the IRS successfully stopped over 99 percent, but we estimate that approximately 150 to 200 erroneous refunds were issued in 2001. In one case concerning a slavery reparations refund of \$500,000, the IRS filed an erroneous refund suit and successfully recovered most of the refund.

Mr. Chairman, we have a two-part program to detect the reparations claims. Employees are trained to spot certain characteristics and questionable returns during pipeline processing. This is an important first line of defense. In addition, we have recently begun making use of a computer process developed by the Treasury Inspector General for Tax Administration (TIGTA) to identify illegal slavery reparations claims.

We did experience a delay in updating this program for the tax year 2001 changes. This update has now been made and the program will be run against all previously processed returns to identify any additional false claims that might have resulted in erroneous refunds. It will serve as a second line of defense in preventing issuance of these refunds going forward.

We have also requested the development of a National Standard Application (NSA) that will allow us to implement and maintain permanently a program similar to that developed by the TIGTA. Moreover, this program will include enhanced ability to extract data on other types of frivolous filings.

In addition to the problem presented by taxpayers submitting frivolous returns, this type of promoted schemes manifests itself in another way – by encouraging taxpayers not to file returns at all.

For example, taxpayers may be encouraged to claim a large enough number of exemptions on their W-4 forms that they submit to their employer so that they have no taxes withheld and no need to file a return. Each year, approximately 600,000 questionable W-4s (QW4s) are forwarded to the IRS from employers. A W-4 is considered questionable if the employee claims more than 10 exemptions or claims to be exempt from withholding. Of the 600,000 or so QW4s, we estimate that, after processing, approximately 58,000 cases will require letters to be sent to the employees or employers.

Another problem is that taxpayers with income that is not withheld at the source may simply not file returns. Some portion of these unfiled returns were caused or influenced by promoters encouraging taxpayers not to file returns. While we do not know what proportion of non-filing is caused by promoted schemes, it is clear that even a small portion of this large number makes this a very significant problem.

### **Warning and Informing**

As part of our larger efforts to alert taxpayers and tax practitioners to tax scams and fraud schemes, last July, we linked our [www.irs.gov](http://www.irs.gov) web site to the Criminal Investigation "Tax Fraud Alerts" page located on the Treasury web site. This site puts together in one location a wealth of information on these schemes, as well as case summaries of those convicted of committing the crimes. It can be reached by going to the IRS web site ([www.irs.gov](http://www.irs.gov)) and clicking on the button, "Tax Scams/Fraud Alerts." Taxpayers can also reach it from the Department of Treasury's web site ([www.ustreas.gov/irs/ci/tax\\_fraud](http://www.ustreas.gov/irs/ci/tax_fraud)). As previously discussed, taxpayers who have questions on these subjects call also us at 1-800-829-0433 or they can e-mail us at [irs.tax.shelter.hotline@irs.gov](mailto:irs.tax.shelter.hotline@irs.gov).

In August 2001, the IRS Chief Counsel prepared and published a 25-page legal summary addressing false arguments about the legality of not paying taxes or filing returns. "The Truth About Frivolous Tax Arguments" can be viewed and downloaded from our web site. It not only debunks these false arguments, it also provides a summary of the law and relevant legal decisions involving the claims.

We are also working closely with the national and local media to get the truth out to taxpayers about these scams. For example, we issued a nationwide alert in January 2002, "The Dirty Dozen: IRS Warns of 12 Common Schemes," where we described the more common scams being peddled by con artists. We have also issued press releases/alerts warning taxpayers against the Section 861 and slavery reparations schemes.

In addition, we send letters to employers who appear to be participating in the Section 861 "employer abatement program" schemes, explaining why their claims were false and the serious consequences that can arise from making them. We direct them to make contact with an IRS official to make the appropriate adjustments to their accounts and to correct their employees' information reports. We also send a letter to affected employees informing them of possible courses of action and their obligations under the law.

Mr. Chairman, many of our volunteer sites also offer tax preparation on specific days to non-filers. For example, on April 6, 2002, the Richmond Territory began working with representatives from the local Taxpayer Education and Communication (TEC) organization and Tax Advocate organizations, along with the state of Virginia, to offer tax assistance to Virginia taxpayers who have not filed federal tax returns for years 1998 and later. It is estimated that 50,000 Virginia taxpayers did not file 1998 tax

returns. The majority of these taxpayers reside in the greater Richmond area. The event has been publicized on local television and radio shows, and in area newspapers.

Outreach on the W-4 problem will focus on those locations where research data indicates there is a problem. For example, our Stakeholder, Partnership, Education and Communication (SPEC) organization is currently working with representatives from the Human Resources Department of the Naval Shipyard to develop a flyer, advising workers of the correct procedures for completing the Form W-4. The flyer will provide the rules and regulations, along with the penalties associated with filing a fraudulent Form W-4. It is anticipated that the flyer will be sent with paychecks during the summer months.

Mr. Chairman, I would like to spend a few minutes describing in detail the extraordinary outreach campaign we mounted during the last two filing seasons to inform and warn taxpayers against the fraudulent slavery reparations scam.

Raising public awareness was key. Based on information we provided, stories on slavery reparations claims have appeared on all of the major television news and radio programs, as well as in most major newspapers. We have also made significant outreach to African American media outlets, with stories placed on the "Tom Joyner Morning Show" (radio), *The Washington African American*, *The Chicago Defender*, *Black Voices* and *Black Enterprise Magazine*.

As an adjunct to our media operation, our Taxpayer Education and Communication (TEC) and SPEC organizations have been conducting outreach to leading voices in the African-American community. Materials were distributed nationally and locally to African-American churches and religious coalitions, fraternities, sororities and associations, including the NAACP and the Urban League.

On January 23, 2002, I also met with the Executive Committee of the Congressional Black Caucus to discuss our concerns regarding the increasing number of slavery reparation scams and the significant number of false tax claims. I outlined to the Caucus how the scams work and what kind of person/group the scam promoters are targeting.

The chair of the Caucus, Texas Congresswoman Eddie Bernice Johnson, and other members of the Executive Committee, immediately supported IRS action with regard to this matter. The following day, the IRS issued a press release, "Slavery Reparation Scams Surge, IRS Urges Taxpayers Not To File False Claims." On the same day, the Congressional Black Caucus issued a press release supportive of our actions.

I also appeared at press conferences with D.C. Delegate Eleanor Holmes Norton and Maryland Representative Elijah Cummings. In addition, the IRS Office of Legislative Affairs provided information and statistics to Representatives Bobby Rush (IL), Sheila Jackson Lee (TX), and Eva Clayton (NC), for their use on radio talk shows and on individual press announcements.

## **Enforcement Actions Against Promoters**

### *Civil Actions*

The IRS has taken a number of civil enforcement actions against promoters of these frivolous schemes, including 8 injunction cases and 4 referrals to DOJ through FY 2002.

For example, the IRS has filed lawsuits against three promoters of Section 861 schemes. Injunctions have been entered against two of the three promoters. District Courts have consistently ruled in the IRS' favor in these cases, including awarding sanctions to the government.

In November 2001, the Department of Justice filed lawsuits in federal courts in three states to crack down on a nationwide bogus tax refund scheme based on a misinterpretation of Section 861 of the Internal Revenue Code. Two of the suits named leading promoters of the "Section 861 argument" – Thurston Bell of Hanover, Pennsylvania and David Bosset, formerly of Clearwater, Florida and now supposedly, Spring Hill, Florida. In the third case, the government sued an Atlanta accountant and tax return preparer, Harold E. "Hal" Hearn, alleging that he had prepared federal income tax returns for taxpayers in 11 states that improperly claimed tax refunds or reported no income.

The Justice Department pointed out that the IRS issued four public announcements in 2001 informing the public that the Section 861 argument is frivolous. Despite these and other warnings, Bell, Bosset and Hearn continued to solicit clients, collect fees for erroneous tax advice, and hamper IRS efforts to collect proper tax liabilities. The Justice Department has asked the three federal courts to enjoin the three men from further promoting the frivolous Section 861 argument and to bar Bosset and Hearn permanently from continuing to prepare federal income tax returns. In January 2002, the court permanently enjoined Hearn from promoting abusive tax shelters and preparing returns with the I.R.C. section 861 argument.

On March 26, 2002, a Federal District Court in Florida ordered David Bosset of Spring Hill, FL to stop preparing bogus tax returns and promoting a fraudulent tax scheme. According to the Department of Justice press release, the court also ordered Bosset to provide the Justice Department a complete list of clients back to 1998, including their social security numbers and other information, and to send the Department copies of every federal tax return or other document he prepares or sends to the IRS on behalf of others.

Eileen J. O'Connor, Assistant Attorney General for the Justice Department Tax Division, stated: "It is impossible to tell how much money the court has just saved the Federal Treasury and law-abiding taxpayers by ordering Mr. Bosset to stop preparing and filing false income tax returns. This court's action should alert people who promote or



rely on this or other bogus tax schemes to the fact that their days of defrauding the public are numbered.”

Last month, the Justice Department filed suit in federal court in Tampa seeking to stop a Florida man, Douglas P. Rosile, Sr., from promoting a tax refund scheme that allegedly has been used to under-report tens of millions of dollars of tax liability for nearly 200 clients in 32 states. The complaint alleges that all the bogus refund claims prepared by Rosile were based on the erroneous Section 861 assertions.

Assistant Attorney General O’Connor commented, “Taxpayers who participate in this and other patently frivolous schemes risk substantial civil and criminal penalties. The Justice Department is committed to stopping abusive promoters who seek to bilk the U.S. Treasury.”

The government complaint states that Rosile’s bogus claims, had the IRS not detected them, would have resulted in a loss of over \$36 million to the Treasury. The complaint refers to one refund claim for \$7.3 million. In its complaint, the Government asks the court to order Rosile to turn over his clients’ identities and all related records.

In addition, we sent letters to the Department of Justice authorizing the filing of suits for injunction against slavery reparations promoters/preparers in 6 cases. The Department of Justice has now filed two injunction actions.

On March 6, 2002, the Department of Justice filed civil suits in Mississippi and Virginia to enjoin tax return preparers from preparing income tax returns claiming bogus refunds based on a supposed tax credit for slavery reparations. The lawsuits also seek to require the defendants to give the government their complete client lists. The complaints were filed in federal courts in Richmond, Virginia and Jackson, Mississippi.

According to the complaints filed, the two defendants prepared and filed returns and amended returns claiming bogus refunds based on tax credits for reparations for slavery or segregation. One defendant prepared returns claiming bogus refunds in amounts ranging from \$8,000 to \$500,000, while the other prepared returns claiming refunds generally in the amount of about \$43,000.

The complaint filed in Mississippi alleges that Andrew L. Wiley of Durant, Mississippi is believed to be responsible for helping to prepare as many as 3,910 returns claiming a total of approximately \$168 million in improper reparation refunds. The complaint filed in Richmond alleges that Robert L. Foster prepared bogus reparation claims exceeding \$2 million.

### *Criminal Investigations and Actions*

IRS Criminal Investigation is also working closely with all parts of the IRS to investigate and refer for prosecution individuals and companies that willfully failed to file or pay employment taxes. We are making solid progress on this front: case openings

increased by 75 percent from FY 2000 to FY 2001 and already during the first quarter of this fiscal year, we are at 56 percent of our totals for last year. And many of those who bought into these schemes soon discovered that they had embarked on a perilous legal and financial path.

Since FY 1999, 141 individuals were sentenced to federal prison, a halfway house or home detention on employment tax issues. Nearly 84 percent of those convicted of evading employment taxes were sentenced to prison for an average of 20 months and were ordered to make restitution to the government for the taxes evaded plus interest and penalties.

We have also launched over 20 criminal investigations against promoters of the Social Security "1041" schemes and have seven convictions to date, including one involving a sheriff in South Carolina who steered unsuspecting taxpayers to one of the scam preparers. For those convicted of these crimes, jail time ranged from 36-66 months.

Some promoters of the slavery reparations scam have been charged criminally. For example, in October 2001, Vernon T. James of Carrollton, Texas was convicted of preparing false, fictitious and fraudulent personal federal income tax returns claiming the reparations credit. In January, a federal judge sentenced James to six and one-half years in prison and ordered him to pay \$566,418 in restitution.

#### *The Internet and Schemes and Scams*

Mr. Chairman, at last year's hearing, the Committee expressed concern about promoters using the Internet to hawk their schemes, and also the possibility of the IRS working with the Federal Trade Commission to close these sites on the grounds of consumer fraud.

We are working on this problem in two ways. First, we are using our authority under IRS sections 6700 and 7408 to investigate promoters and to potentially take injunctive action.

In FY 2000, as part of a special project, we identified 26 potentially abusive web sites. These were subsequently reviewed for Abusive Tax Promoter Examination (IRC Section 6700) and possible injunctive action (IRC Section 7408). Seven of these have been formally opened for IRC 6700 Examinations and possible injunctive action. Based on this promising initiative, we developed and implemented last month new computer methods and techniques to detect abusive tax schemes marketed over the Web.

In addition, we have met with the FTC to explore cooperative efforts in this area. We are actively seeking several abusive tax scheme web sites as test cases for making referrals to FTC and to help establish a referral procedure.

The FTC has regulatory and injunctive authority regarding false advertising in the media. This would include Internet advertising, as well as TV, radio, newspapers, and magazines. In our meetings with FTC, they indicated they would review referrals from the IRS for false or misleading advertising on the Internet. If the referral meets the standards established by FTC, then our FTC contacts indicated a willingness to act against the Internet web site.

There are, however, significant limitations to this approach. Disclosure rules (IRC 6103) prevent us from adding information from our internal databases or adding data obtained from investigative/examination work to enhance the referral. Therefore, the referral would need to stand on the content of the web site alone.

Another weakness in this methodology is that promoters of organized tax evasion schemes often maintain multiple web sites. These sites have different names, but use the same or similar web pages from site to site. An FTC action may close one site or several, but promoters can have new sites set up in anywhere from a few days to only a few hours, oftentimes, with new company names.

Finally, another consideration is that many promoters have become more sophisticated with their web page offerings and do not make blatant offers to establish abusive tax schemes, and some potentially abusive web sites are more political in nature than promotional. This would make them difficult injunctive cases for FTC, due to “Freedom of Speech” considerations.

### **Enforcement Action Against Non-filers**

IRS has implemented a multi-functional, comprehensive effort called the National Non-filer Strategy. The overall goal of this strategy is to bring taxpayers back into compliance and keep them there. In addition to nonfilers, the IRS will reach out to individual taxpayers who are not legally required to file, but are potentially entitled to refunds or credits.

On the civil side, we have both the Questionable W-4 processing and Automated Substitute for Return (ASFR) programs. As previously described, each year, approximately 600,000 questionable W-4s (QW4s) are forwarded to the IRS from employers. A W-4 is considered questionable if the employee claims more than 10 exemptions or claims to be exempt from withholding. After data is inputted and reviewed, the subsequent cases are forwarded to the Fresno Service Center where the actual leads are worked.

For those who refuse to file a return, the Service Center ASFR Unit prepares a substitute return for the individual under the authority of the IRC 6020 (B) and issues a Statutory Notice of Deficiency. After the “dummy” return is posted, the IRS sends a letter informing the taxpayer of the proposed assessment and of all appeal rights.

IRS Criminal Investigation vigorously pursues prosecution and prison sentences for individuals who violate the tax laws, including non-filers. In FY 2001, it had 269 prosecution recommendations, 257 indictments/informations and 219 convictions. There was an 83.9 percent incarceration rate and an average of 43 months to serve in prison.

## **FALSE REPRESENTATIONS OF FACTS TO CLAIM IMPROPER DEDUCTIONS OR CREDITS**

### **What They Are**

Although they are sometimes grouped together, this category of promoted schemes is different from those that depend on false descriptions of the law. These devices, marketed primarily to individuals and small businesses, entice the promoters' targets into misrepresenting the facts so they can claim improper deductions or credits. In this regard, they are potentially more serious because it is less obvious to many people that they are bogus and some may believe that they are less likely to be detected by IRS.

For example, so-called home-based business schemes purport to offer "tax relief." The promoters of this scheme, which is estimated to involve up to 50,000 taxpayers, claim that individual taxpayers can deduct most, or all, of their personal expenses as business expenses by setting up a bogus home-based business. This scheme usually results in lost taxes of \$5,000 to \$15,000 per case.

The following are some examples of personal expenses that are not deductible, but are commonly claimed as business expenses in home-based business tax avoidance:

- Deducting all or most of the cost and operation of a personal residence. For example, placing a calendar, desk, file cabinet, telephone, or other business-related item in each room does not increase the amount that can be deducted.
- Deducting a portion of the total house payment is not allowable if the business is not real.
- Paying children a salary for services, such as answering telephones, washing cars or other tasks and then deducting these costs as a business expense is not allowed.
- Deducting education expenses from the salary wrongfully paid to children as employees also is not allowed.
- Deducting excessive car and truck expenses when the vehicle has been used for both business and personal use is not allowed.
- Deducting personal furniture, home entertainment equipment, children's toys, etc. is not allowed.
- Deducting personal travel, meals, and entertainment under the guise that "everyone is a potential client" is not allowed.

Another fraudulent investment scheme induces people to improperly use the Disabled Access Credit. The credit is intended to help small businesses offset costs associated with bringing their businesses into compliance with the Americans with Disabilities Act (ADA).

Many of these ADA credit schemes have surfaced across the country. Most appear to involve Ponzi-type financing and promise erroneous claims of tax benefits. In this scheme, investors are to receive a credit for their investment in providing telephone equipment for the disabled.

Mr. Chairman, the Earned Income Tax Credit (EITC) program also continues to provide an opportunity for unscrupulous tax return preparers to prey on taxpayers in hopes of generating refunds to which they are not entitled.

For example, these crooked preparers may “share” one client’s qualifying children with another client in order to allow both clients to claim the EITC. Under the scheme, if one client has four children, they only need to list two for EITC purposes to get the maximum credit. The preparer will list two children on the first client’s return and list the other two on another client’s tax return. The preparer and the client “selling” the dependents split a fee. The IRS prosecutes the preparers of such fraudulent claims, and participating taxpayers could be subject to civil penalties.

Refund scheme operators may also approach taxpayers wanting to “borrow” their Social Security Number or give them a phony W-2 so it appears that they qualify for a big refund or other credits, including the EITC. They also prepare returns for taxpayers who have children but have no income, inflating income by preparing phony Schedule C attachments showing false income from a business or occupation. The unscrupulous promoters of schemes may promise to split the refunds with taxpayers.

### **Identifying Schemes, Promoters and Participants**

We have a number of important tools at our disposal to identify those schemes involve submitting false returns to claim refunds.

Since its inception in January 1977, the Questionable Refund Program (QRP) has been responsible for the detection of over \$2 billion in fraudulent refunds and has been successful in stopping 86 percent of it. QRP schemes involve tax returns claiming refunds based on false income, false federal income tax withheld and false refundable credits, such as the EITC, Fuel Tax Credit, Foreign Income Tax Credit, etc. In addition, the program has helped identify other scams and schemes, such as abusive trusts and Section 861 frivolous arguments.

To detect these false returns, we placed Questionable Refund Detection Teams (QRDT) at each of our 10 campuses. They are located at Fraud Detection Centers and report directly to the Director of Refund Crimes in our Criminal Investigation division. These teams can sound an alarm at the earliest possible stage when we detect anomalies in refund filings. We also receive alerts from other campus functions, Electronic Return Originators, financial institutions, return preparers and concerned citizens.

We also employ the Electronic Fraud Detection Systems (EFDS) – a computer system used by CI to help identify potentially fraudulent electronically filed (ELF) and

paper returns. It also increases the data available for analysis and assists in the development of information relating to schemes detected by the QRDTs.

In addition, CI's Return Preparer Program (RPP) identifies, investigates and prosecutes abusive return preparers. The program was developed to enhance compliance in the return-preparer community by engaging in enforcement actions and/or asserting appropriate civil penalties against unscrupulous or incompetent return preparers.

Mr. Chairman, this is a significant problem for both the IRS and our taxpayers. Abusive return preparers frequently prepare bad returns for large numbers of taxpayers who, at best, are stuck with paying additional taxes and interest and at worst, depending on culpability, are subject to penalties and perhaps even criminal prosecution.

In addition to the fraud scheme detection tools, just described, we have other methods to identify potentially erroneous refund claims based on the EITC and other dependent credits and exemptions. One of the most important is the Dependent Database (DDB). Using data provided by the Department of Health and Human Services and Social Security Administration, it is designed to identify potential non-compliant returns during returns processing.

For example, when a child's Social Security Number is used on multiple returns, the database helps determine which taxpayer was likely to be erroneously claiming tax benefits on behalf of that child. We have moved beyond testing to using the DDB application nationwide as part of our Examination Program and for the identification of non-compliant taxpayers and paid preparers.

As part of our multi-year Collection Re-engineering Program, the Electronic Fraud Detection System is also being enhanced to include selected Business Master File data that will permit research, analysis and evaluation of fraud detection scenarios for business returns.

Mr. Chairman, let me finally note that identifying scams based on false deductions is more difficult than detecting some of the refund scams. It is a much more tedious process that requires us to discern patterns in a post-filing environment. Audits often tip us off to an emerging problem. We are currently working to develop new statistical techniques to make this process easier.

### **Notify and Warn the Public**

As is the case with schemes involving false descriptions of the law, public awareness is essential to combating these schemes. Many of the press releases we issued on the bogus "Section 861" scams, such as "The Dirty Dozen", also covered those involving a fraudulent representation of the facts. When a particular scheme appears to be gaining popularity, we correspondingly ratchet up our outreach program.

In February 5, 2002, we issued a press release on Home-Based Deductions. We warned taxpayers that any tax scheme that claims a person can deduct what would normally be personal expenses should be considered highly suspect. We also informed taxpayers, who claimed such deductions on a past tax return and now want to file an amended return, to contact the IRS at our toll-free number at 1-800-829-1040.

We will soon release a tri-fold pamphlet regarding Home-Based Business Tax Avoidance Schemes. This pamphlet will be widely distributed through our web site, and our nationwide network of channels with practitioners, business and trade organizations and educational institutions.

On February 8, 2002, the IRS issued a nationwide press release warning taxpayers, especially the elderly, who are likely targets of the promoters, to be beware of scams involving the Americans with Disabilities Act credit.

To help us better combat these schemes, we are also conducting extensive outreach to the tax practitioner community. These efforts include IRS-authored articles in professional journals and corporate publications, including that of H&R Block. I and senior IRS officials also speak on a regular basis to the annual meetings and conventions of the major national associations, organizations and companies representing practitioners and preparers, such as the National Association of Enrolled Agents, the American Institute of Certified Public Accountants and the National Association of Tax Practitioners, to name but a few.

In addition, we conduct bi-monthly liaison meetings to brief our stakeholders on any emerging issues and then e-mail them any follow-up notices. This year, our highly successful nationwide Tax Forums, which in 2001 attracted 14,000 tax practitioners, will also offer, for the first time, seminars on the tax scams and schemes being discussed today, including refund/credit fraud. This is an excellent opportunity to convey our message to a very large audience, who in turn, can relay it to their clients.

Moreover, to help improve compliance with EITC on returns submitted by tax preparers, we established a nationwide EITC preparer outreach program in the fall of 1998. These practitioners account for 68 percent of the \$8.4 billion in 1998 EITC overclaims.

As part of the program, IRS revenue agents visit tax professionals nationwide to provide individual assistance and to answer any questions about the EITC. Some of these visits will also include a review of files to determine if due diligence requirements for the preparation of EITC have been met. We have also sent warning letters to hundreds of thousands of EITC taxpayers.

### **Enforcement Action Against Promoters and Participants**

Over the past five years, the IRS has also executed a full range of compliance activities for organized EITC fraud that include criminal prosecutions of promoters.

During the past three fiscal years, 176 subject criminal investigations were opened on questionable refund schemes related to fraudulent EITC claimed. These investigations identified a minimum of 7,811 questionable returns claiming a minimum of \$17 million in false EITCs. During this same time period, 130 criminal investigations were recommended for criminal prosecution and 116 persons were criminally convicted of income tax fraud for the various EITC fraud schemes.

Mr. Chairman, we have a solid track record of convictions for those prosecuted for misrepresenting the facts, and the perpetrators have paid a heavy price. For example, on September 4, 2001, in Brooklyn, NY, Jose Raul Diaz was sentenced to 18 months in prison followed by 3 years supervised release. In addition, Diaz was ordered to pay restitution of \$120,000 and a special assessment of \$100. Diaz pled guilty in September 2000 to filing false and fraudulent federal tax returns.

According to the press release, Diaz provided tax services to low-income clients, many of whom were immigrants with poor English language skills and little familiarity with the tax system. Diaz falsely increased his clients' tax refund checks through a variety of fraudulent means, including claiming non-existent children as dependents, misrepresenting the client's filing status, and claiming fraudulent childcare expenses.

In many cases, Diaz forged the clients' signatures on tax returns or had clients sign blank tax returns, so that the clients were unaware of the false information. Diaz also listed his own address as the taxpayer's address, so that the refund check would be delivered to him. He would cash the checks himself, often stealing all or a portion of the fraudulent refund.

Mr. Chairman, I would like to make a last important point regarding the EITC program. Promoted tax schemes are only a part of the problem. Overclaims for a wide variety of reasons – from confusion to unscrupulous preparers – continue to be a problem and we want to develop the best possible solutions. Last month, I announced that we convened a high-level IRS/Treasury task force to review comprehensively the EITC program.

It will develop recommendations to achieve the congressional objectives of the EITC program while making it easier for taxpayers to comply with the rules and for the IRS to efficiently and effectively administer them. The Assistant Secretary for Tax Policy and I are personally overseeing this task force and will present its recommendations to Secretary O'Neill within four months.

#### **SCHEMES TO HIDE INCOME USING TRUSTS AND OFFSHORE BANK ACCOUNTS**

##### **What They Are**

In the last few years, the IRS has detected a proliferation of schemes designed to allow upper income taxpayers to hide income. Of the four categories of schemes, this is the largest in loss of revenue to the Treasury, the hardest to detect, and the most insidious



in undermining the fairness of the tax system. Participants in this category of scheme include chief executive officers of large companies, high income professionals such as athletes, actors, doctors, lawyers, authors, business owners and even law professors – in other words, people who should know better.

The devices used to hide income include trusts, both foreign and domestic, and offshore bank accounts. A particularly important device has been the use of credit cards issued by banks in tax haven countries which are used as a convenient and efficient way of bringing back and spending the money that is hidden offshore.

Currently, there are two prevalent fraudulent schemes being promoted: the “domestic scheme” and the “foreign scheme.” The domestic scheme involves a series of trusts that are formed in the U.S., while the foreign trust scheme is formed offshore and outside the jurisdiction of the U.S.

The trusts involved in the schemes, either foreign or domestic, are vertically layered with each trust distributing income to the next layer. The goal of this elaborately tiered structure is to fraudulently reduce taxable income to nominal amounts. Although these schemes give the appearance of the separation of responsibility and control from the benefits of ownership, they are, in fact, controlled and directed by the taxpayer.

A network of promoters and sub-promoters, who may charge \$5,000 to \$70,000 for their packages, often market these schemes. This fee enables taxpayers to have trust documents prepared, to utilize foreign and domestic trustees, and to use foreign bank accounts and corporations. In some instances, tax return preparer services are also made available.

Mr. Chairman, let me also stress that while the abusive trusts are the more prevalent of the schemes we see today, the promoters are extremely creative and will use other vehicles, such as partnerships, to try to disguise their illegal activities.

### **Domestic Abusive Trusts**

The abusive trust scheme generally starts with the transfer of a business or other source of professional income to a trust. Taxpayers then typically offset income by overstating business expenses or deducting personal expenses from the income in the trust. To cover their tracks or mislead, these schemes often use tiered multiple entities, such as partnerships, limited liability companies, or secondary level trusts.

For example, in some promotions, taxpayers are advised to create an Asset Management Company (AMC) in order to give the false impression that the taxpayer is not managing his or her business. This starts the layering process.

The next step is to form a business trust, also a domestic trust. In effect, the client elects to change the structure of his or her business from either a sole proprietorship or corporation to a trust. The AMC may be the trustee of the business trust and there may

be multiple layers of trusts under the first trust. The scheme gives the appearance that the taxpayer has given up control of his or her business to a trust and progressively reduces the income distributed to the beneficiaries by charging administrative or other expenses at each level. Of course the transfer of income into the trusts is a sham because the taxpayer continues to control and enjoy the use of the income and assets.

### **Offshore Trusts and Accounts**

Similar to the domestic arrangements, foreign packages usually start with an Asset Management Company, a business trust, and distribute income to several trust layers. However, these foreign promotions also attempt to take funds offshore and outside U.S. jurisdiction. These schemes involve offshore bank accounts, trusts, and International Business Corporations (IBC's) created in "tax haven" countries.

Diversion of income to offshore tax havens with strict bank secrecy laws adds an additional layer of complexity, which in turn, has permitted the taxpayers to hide the income more effectively. However, once the income is offshore, the taxpayer has the problem of getting the money back when he or she wants to spend it. One method individuals have been using to divert income to tax havens and evade their U.S. tax obligations, while still maintaining easy access to their funds, is by obtaining credit cards issued by banks in these tax havens

As *The Wall Street Journal* reported on March 8, 2002, these cards are even hawked on the Internet: "For example, a palm-draped Web site called Cardster this week advertised a 'top security anonymous offshore no ID ATM Cirrus debit card' as well as other services."

Mr. Chairman, let me emphasize that while it is not illegal to have a credit card issued by an offshore bank, there is ample basis for believing that many people are using offshore credit cards to repatriate funds hidden offshore to evade paying U.S. taxes. These credit cards are used by the taxpayer in the U.S. to withdraw cash and to pay for everyday expenses like groceries, medical bills, gasoline, and other miscellaneous expenses. They provide easy access to offshore funds and accounts in tax haven countries that allow income to be hidden.

### **Identifying Promoters and Taxpayers: Tools and Results**

#### *Organizational Focus*

These abusive trust schemes are a significant problem, the magnitude of which we are just beginning to understand. Over the past two years, we have taken aggressive steps to identify systematically promoters who sell these schemes and taxpayers who use them to hide income, including creating an abusive tax scheme program structure. In 2001, Fraud, Anti-Money Laundering, Abusive Schemes and the Lead Development Center

were placed under one IRS executive to increase program oversight and allow a better flow of information between these programs. Let me describe how the structure works.

The civil Lead Development Center (LDC) was established to identify and develop cases on abusive tax promoters. The Center works leads received from within the IRS, or from external sources, and conducts Internet searches looking for abusive tax promoters and promotional materials.

Mr. Chairman, in this regard, let me point out that following last year's hearing, we met with representatives of the Federal Trade Commission who had discussed their methods for detecting consumer fraud found on the Internet. Beginning this month, we have been employing similar computer methods and techniques to detect abusive tax schemes marketed over the Web.

Abusive Schemes/Flow-through groups were also established in each of 16 area offices to audit the abusive schemes, tax shelters and John Doe Summons cases once they are identified and developed. In addition, four Special Enforcement Program (SEP) groups were created in IRS Small Business/Self-Employed to focus on the offshore abusive schemes and the John Doe Summons cases. Each area has identified a manager who will coordinate with the LDC and Abusive Schemes program managers to ensure these cases are timely assigned and properly worked.

The people in this civil structure work closely with the lead development centers in our criminal division to ensure that leads on potential criminal cases are appropriately developed and referred. When our examiners and revenue officers find serious cases of non-compliance from any source, the taxpayers will be referred for criminal investigation. The number of fraud referrals increased by more than 15 percent when compared to last fiscal year.

In addition, one of the most powerful tools that we use to ensure compliance is matching information received from businesses with information reported by individual taxpayers. Trusts and partnerships also must report income to their partners or beneficiaries and we can use this data to identify cases that use trusts and partnerships to hide or underreport income.

This year, the IRS began capturing data from 16.8 million K-1 forms. In 2002, the IRS is changing its processing procedures and will process and match K-1s reporting almost \$700 million of income and also, importantly, reported losses on trusts and passthroughs. This will help us to find potential problem cases and to follow up, when necessary, with audits.

#### *Special Initiative to Identify Offshore Credit Card Accounts*

In the past year we have also had considerable success with one major initiative to identify promoters and taxpayers who hide money in offshore tax havens.

A John Doe summons issued in 2000 to MasterCard yielded a large database of transactions using cards issued by banks in Antigua and Barbuda, the Bahamas and the Cayman Islands. Many of these cards appear to have been issued to U.S. customers. Hundreds of cases have been initially identified for civil audits or criminal investigation. The IRS is also matching these cardholders against open and closed examinations and collection, criminal, and bankruptcy cases, as more identification data is developed.

Mr. Chairman, we are following up on this initial action that proved to be so successful. First, on March 25, 2002, we petitioned the U.S. District Court in San Francisco for permission to serve a John Doe summons on VISA International, along the lines of the MasterCard summons, seeking records on transactions using cards issued by banks in over 20 tax haven countries. On March 27, the District Court authorized us to serve the John Doe Summons.

Second, also on March 25, 2002, we filed in the U.S. District Court for the Southern District of Florida a stipulated agreement with American Express to provide a sample of its records for 1998 and 1999 on cards for U.S. taxpayers with transactions in the U.S. and addresses in Antigua and Barbuda, the Bahamas, or the Cayman Islands upon entry of a court order. On March 26, 2002, the District court signed an order directing the agreed-upon production.

Third, we will be seeking permission from District Courts across the nation to serve scores of John Doe summonses on merchants to assist us to identify many more of the actual individual taxpayers using the cards in the MasterCard database.

### **Notifying and Warning the Public**

We want to make sure that potential participants know the serious consequences of these schemes to hide income. These are crimes – plain and simple – and the judicial system has little sympathy for the perpetrators. As described in the following section, those convicted – both promoters and clients – are facing large fines and penalties. Some are losing their homes and are being stripped of their professional licenses. And they are going to prison for substantial amounts of time.

Mr. Chairman, we have taken both a broad and focused approach to educating the public about abusive schemes and scams. As previously noted, our web site ([www.irs.gov](http://www.irs.gov)) has a hot link from its front page to CI's special "Tax Fraud Alerts" section where taxpayers can learn about both abusive trust schemes and criminally-prosecuted case summaries.

Also listed is the toll-free hotline to report suspected tax fraud activity (1-800-829-0433). Following the suggestions made by the Committee at last April's hearing, we have also added so-called "METATAGS" that will help direct to the CI site taxpayers using search engines to find information about abusive trusts.

As part of our outreach efforts, IRS Criminal Investigation also has a cadre of trained executives who are available and have appeared on numerous radio and television programs, including call-in shows where they are able to answer listeners' questions about these scams.

We know too that these schemes are being marketed to upper-income taxpayers, often professionals, such as those in the medical and other professions. It is important that these individuals know that participating in one of these scams is often a costly endeavor, both personally and professionally. To this end, IRS has written and placed articles, such as "Unscrupulous Trust Promoters Target Medical Profession," in the publications of the American Academy of Otolaryngologists and the American Academy of Orthopedic Surgeons. Other articles have been placed or will appear in other professional journals.

Recently, I also met with the leadership of the American Medical Association, American Dental Association, and numerous other health care professional associations on how their members were being targeted by the scheme promoters. Through this event and the associations represented at it, we have the potential to reach over 750,000 professionals with an important warning. We are making similar outreach efforts to the construction industry.

We are also using our network of national and local relationships with tax practitioners to provide them information about the prosecutions of taxpayers who participate in these schemes so that they can warn their clients and potential clients of the dangers of succumbing to the offerings by unscrupulous practitioners and promoters.

Mr. Chairman, our efforts, in conjunction with those of the Justice Department, on the John Doe summons were significantly noted in the press, including front-page coverage in the New York Times, USA Today and placements in the major newspapers. It also garnered coverage on most of the major nightly news programs, including ABC World News Tonight and CNN.

This observation from a recent *Christian Science Monitor* editorial illustrates the reaction we are receiving: "The Internal Revenue Service often has had a bad-guy image for cracking down on average taxpayers who inadvertently make mistakes. But the agency takes on a distinctly good-guy role when it tracks down egregious tax-evasion scams. After all, those who shun their legal obligation to pay taxes simply put a larger burden on everyone else."

### **Enforcement Against Promoters and Participants**

Our enforcement strategy to combat these schemes focuses on promoters and clients who have willfully used these schemes to evade taxes. Further, fraudulent trust issues are addressed through a national strategy that includes the Department of Justice. As part of this strategy, emphasis is placed on multi-function coordination, the

identification of fraudulent offshore promotions, and the use of civil and criminal enforcement actions.

Since 1998, the IRS has closed approximately 5,000 domestic abusive trust cases and proposed \$780 million in taxes for them. Over 100 promoters of these schemes have been identified for whom civil or criminal actions are pending or completed, and another 161 promoter leads are in our database. About 1,500 abusive trust investor cases are currently under examination today.

Suit recommendation letters for injunctions against 11 abusive trust promoters have been referred to DOJ in the past 18 months. We have received one permanent injunction and six suits in total have been filed by DOJ against the remaining 10 promoters. The IRS has been upheld in numerous Tax Court actions on the sham argument. Several prominent criminal convictions have also been obtained in this area, which are discussed at the end of this section.

Since 1997, IRS Criminal Investigation has obtained 156 convictions of individuals for illegal trust schemes. In CY 2001 alone, it had 301 open investigations, including 125 of promoters. Judges have little sympathy or patience for those convicted of these crimes. Here is but one recent example; the CI web site has many more.

On January 7, 2002, in Sacramento, California, three medical professionals were sentenced for their roles in a tax evasion scheme involving the concealment of their income by routing it through bank accounts in the names of trusts located in the United States and abroad.

Richard Shearer, an ear, nose, and throat specialist, was sentenced to 24 months in prison and ordered to pay a fine of \$10,000. Richard D. Pfeiffer, an orthodontist, was sentenced to 27 months in prison and ordered to pay a fine of \$10,000. In addition, the defendants were sentenced to three years of supervised release. Also, the defendants were ordered to pay restitution to the IRS, an assessment of \$200, and prosecution costs of well over \$1,000. The defendants pled guilty on October 1, 2001, to one count of defrauding the IRS and one count of filing a false tax return.

And in February 2001, in the largest IRS enforcement action ever taken, law enforcement authorities in multiple states executed over three dozen search warrants. IRS Criminal Investigation special agents conducted these enforcement actions as part of a series of investigations of alleged illegal offshore trust programs involving the diversion of millions of dollars of income for hundreds of clients.

Six individuals from Massachusetts, New Jersey, Washington, California, and Costa Rica were charged on February 26, 2001 in Federal District court in Boston, Massachusetts, all of whom have been arrested. The charges arise out of the criminal complaint filed in connection with the IRS investigation of Anderson Ark and Associates alleging a conspiracy to launder monies through the use of offshore trusts and other

offshore entities. Keith Anderson, one of the principals, was recently arrested in Costa Rica and is awaiting extradition to the United States.

The program allegedly involved hundreds of clients who diverted millions of dollars through offshore trusts and bank accounts for the express purpose of evading taxation of income earned in the United States. According to the complaint, each of the defendants was a principal in or provided a referral to Anderson Ark and Associates, a self-proclaimed “free enterprise” or anti-tax organization in the business of creating, promoting, and implementing schemes to assist U.S. taxpayers in the evasion of their true, lawful income tax liabilities.

### **Benefits Of A Parallel Approach**

Mr. Chairman, since last year’s hearing, we have dusted off injunctions as another valuable tool we can employ in the fight against these scams and schemes. We have moved aggressively, having sought 10 civil injunctions in cases where some or most have parallel criminal investigations taking place. Without the civil injunctions going forward, these scams would still be operating. Let me provide the context for this promising approach and an excellent example of what it can produce.

While the Internal Revenue Code has both civil and criminal provisions to address abusive promotions, the IRS generally completes a criminal investigation before seeking civil remedies. However, using this methodology to investigate promotions of abusive tax schemes allows the promoters to continue to market the abusive scheme for months or even years while being investigated criminally.

Following the suggestions raised at the Senate Finance Committee hearing in April 2001, a task force was created to determine an effective method of stopping abusive tax scheme promotions while the same promotions are being investigated criminally, i.e., parallel criminal and civil proceedings.

The group was given the task of providing guidelines to the field as to how and when parallel proceedings should be used. Task force members were chosen from the civil and criminal divisions of the IRS, the Office of IRS Chief Counsel and the Department of Justice Tax Division. It is now in the process of making what I am sure will be some important and useful recommendations. We will report these to the Committee at the earliest possible opportunity.

### **ABUSIVE TAX AVOIDANCE TRANSACTIONS**

Mr. Chairman, last month, Assistant Secretary of the Treasury for Tax Policy Mark Weinberger; IRS Large & Mid-Size Business (LMSB) Division Commissioner Larry Langdon; and IRS Chief Counsel B. John Williams testified before the Committee on programs and actions to address the proliferation of abusive tax avoidance transactions.

These transactions are designed and promoted by sophisticated tax professionals and used by both corporations and wealthy individuals to reduce their taxes. They are highly complex and crafted to exploit technical loopholes in the internal revenue laws to obtain substantial and unintended tax benefits.

These abusive tax avoidance transactions are factually complex. A typical transaction may involve multiple entities created solely for the purpose of investing in the shelter, as well as complex financial derivatives. Developing the facts requires an understanding of how complex transactions are structured. Because taxpayers may not provide or have all of the relevant documents, IRS examiners must obtain the information from third parties.

Abusive tax avoidance transactions are also legally complex. Promoters carefully scrutinize the tax laws to find loopholes and then design complex transactions to exploit them. Consequently, highly complex and very arcane areas of the tax laws are involved. The transactions also always come with the blessing of a tax opinion. This is a critical point.

For an investor, the tax opinion legitimizes the transaction, purporting to allow an investor to claim a reasonable belief that the tax benefit, no matter how outrageous, was legally justifiable. As a result of these tax opinions, technical tax shelters too frequently result in litigation. Moreover, the tax at issue is large enough, and the outcome is uncertain enough to encourage taxpayers to litigate the issue.

These transactions pose an enormous challenge for the IRS. First and foremost, they are extremely difficult to find on tax returns. Large corporations have complex, voluminous returns, and the only clue to a shelter may be buried deep in the return.

Although corporations already have a disclosure requirement, we believe too many are parsing words, narrowly construing the disclosure rules and broadly construing the exceptions.

On December 21, 2001, the IRS issued Announcement 2002-2, announcing a temporary disclosure initiative designed to encourage greater voluntary disclosure. The number of disclosures received has been both encouraging and discouraging for us. While we have made progress, we are finding that taxpayers and promoters are interpreting the current disclosure rules very narrowly and are disclosing few transactions. Consequently, it is our view that the disclosure regulations need to be revised and expanded. The set of initiatives described by Assistant Secretary Weinberger at the March 21, 2002 hearing fills those needs.

## **PROMOTED SCHEMES: MEASURING OUR RESPONSE**

Mr. Chairman, as I previously discussed, we are in the process of refining many of the estimates about the extent and scope of the various tax scams and schemes.



Indeed, this points to a larger issue. Last summer, the GAO reported to you and Senator Grassley that in order to understand the overall extent of noncompliance and effectiveness of our compliance assurance programs, the IRS has periodically measured voluntary compliance.

Earlier this year, the IRS proposed to reestablish a key component of its ongoing compliance effort to help ensure fairness for America's taxpayers. The National Research Program (NRP) is designed to accurately measure tax compliance while minimizing the need to contact taxpayers during the process.

The NRP is developing innovative approaches to measure taxpayer compliance with the tax law. It will: (1) be far less intrusive and burdensome on taxpayers than previous compliance studies; (2) help the IRS build better compliance programs to more effectively catch tax cheating and help ensure all taxpayers pay a fair share; and (3) help reduce audits of taxpayers who filed an accurate return by at least 15,000 tax returns a year.

As part of ongoing compliance operations, NRP will focus on measuring three key areas of tax administration – filing compliance, payment compliance and reporting compliance. A key element involves measuring the accuracy of reporting information on tax returns. The IRS has overhauled the reporting component to minimize disruptions to taxpayers during the study.

Ultimately, this project will help all taxpayers by giving the agency timely, accurate information about tax compliance. This information will allow the IRS to replace outdated audit formulas and develop compliance efforts directed toward the tax returns most likely to have errors, rather than those from honest taxpayers.

In late fall of this year, the NRP will begin reviewing a small, statistically valid sample of individual returns from the 1040 family. The IRS will work closely with tax practitioners, Members of Congress and other key stakeholders to finalize the project.

Mr. Chairman, let me also point out that in response to a TIGTA report issued last September, LMSB's Office of Tax Shelter Analysis and the Office of Strategy, Research and Program Planning established a research team with the responsibility for: (1) estimating the potential tax revenue impact attributed to these devices; (2) defining the characteristics and behavioral triggers of abusive shelters and (3) developing an abusive corporate issue identification and classification system. In addition, we are developing indicators to measure the organizational progress of our OTSA initiatives.

## **CONCLUSION**

Mr. Chairman, in conclusion, I believe that we are making significant progress combating these illegal tax schemes and scams. However, I do not want to minimize the scope of the problem and the challenges we face. Many of these ploys and schemes are very well organized. To deal with them effectively requires an enormous commitment of

time and resources on our part. At the same time, we must maintain adequate coverage of all other areas of non-compliance. Nevertheless, we will use all of the tools at our disposal to stop these attempts to undermine our tax system and the confidence of the American people in it. Thank you.